The tarnished silver lining

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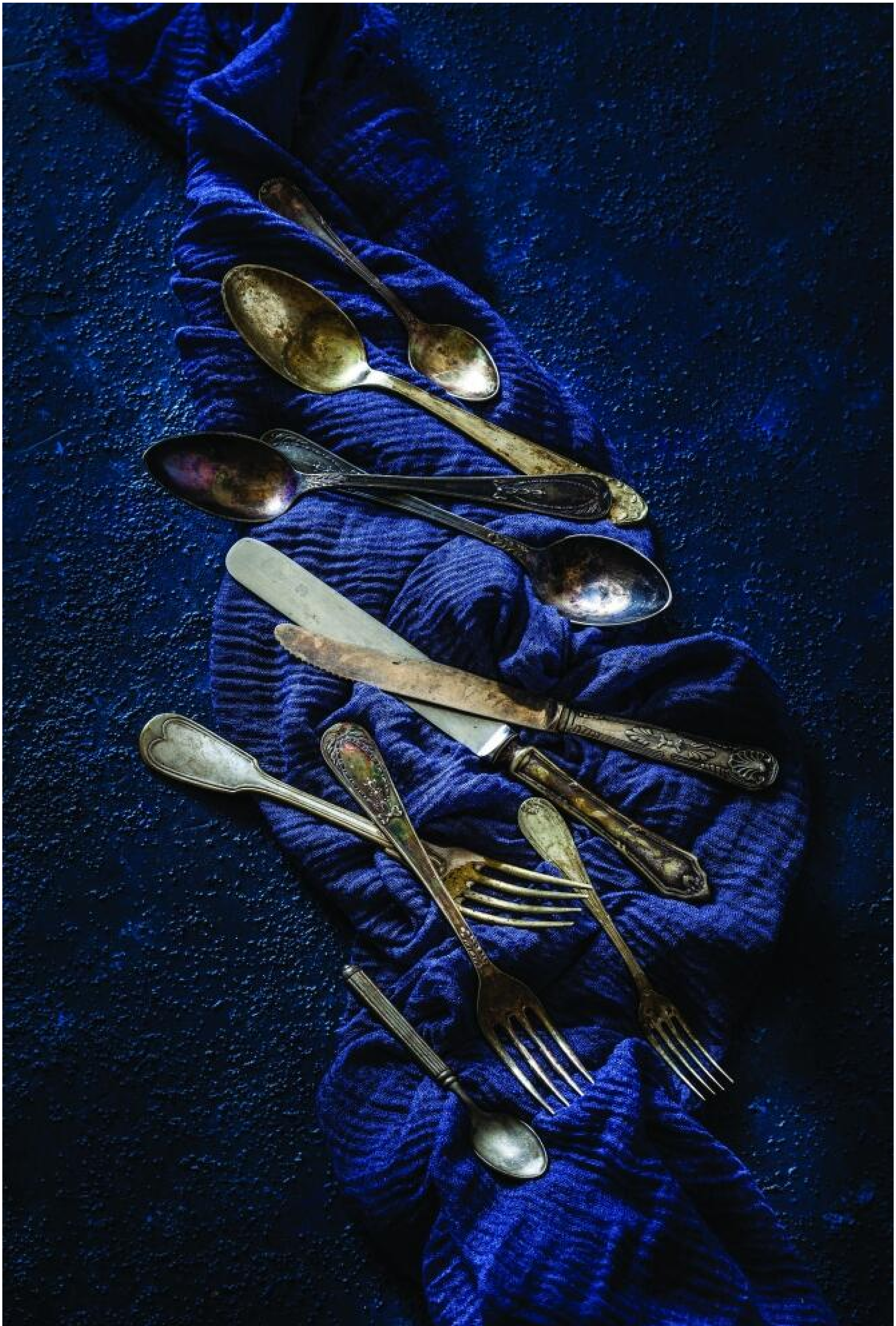

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Jack Sharville considers the issues connected with property impairment under IFRS 16 and its impact on tax deductions

Key Points

What is the issue?

IFRS 16 Leases are relatively new to balance sheets. What happens for tax when they are impaired?

What does it mean for me?

Impairments to leases are likely in many companies considering changes in consumer habits following lockdown, and it is important to treat them correctly for tax.

What can I take away?

If the accounting is right, the tax follows it, except where capital costs are being impaired.

As the lockdown changes the way people work, rest and play, the value of real property must also be reconsidered. Most commercial buildings, from shops to warehouses, to bars and restaurants, have been impacted in one way or another. IAS 36 Impairment of Assets requires that companies conduct impairment tests on those properties. Clearly, where the value of a property has been severely impacted, this will in turn also impact the business's income statements and balance sheet. But why should the tax professional take note?

Not so very long ago, an impairment to land or buildings was only a tax reporting issue, rather than a tax compliance one. The impairment would be capital in nature and would not be deductible against taxable business profits, treated similarly to depreciation. However, for periods beginning on or after 1 January 2019, companies that report under International Financial Reporting Standards (IFRS) or the FRS 101 Reduced Disclosure Framework were required to follow IFRS 16 Leases.

This meant that most property leases that had previously been accounted for as operating leases (known as ‘off balance sheet’) would now be accounted for in a similar way to existing finance leases and the distinction between the two would no longer be required for accounting purposes. The lessee is required to recognise:

- a right of use asset, representing its right to use the underlying leased asset; and
- a lease liability, representing its obligation to make lease payments.

To understand the tax treatment of an impairment to that right of use asset, one should first consider the tax treatment of a right of use asset without impairment.

Tax deductions for lessees of IFRS 16 Leases

Where there is an IFRS 16 lease, the profit before tax will include depreciation of the right of use asset and the interest expense on the lease liability. The accounting works such that this is, across the life of the lease, equivalent to the lease rental costs. Therefore, HMRC agrees (BLM51005) that these are deductible against trading profits, and that no adjustment to trading profits needs to be made.

From a practical perspective, this means that depreciation of right of use assets must be able to be separated from depreciation of other assets, so that it is not inadvertently disallowed. The exception is where the right of use asset includes any capital costs; for example, the capital element of a lease premium, or any capital element of a predicted dilapidations expense. These should be added back as they accrue.

Impairment of a right of use asset Where a right of use asset is impaired, then tax will follow the accounts. This means that a deduction can be taken against taxable profits of a trade in respect of the impairment, to the extent that it does not relate to capital costs as described above. HMRC concurs with this treatment in BLM51020. This merely accelerates the deduction, and typically rental payments will still be made for the remaining years for which no further deduction is available.

It should be noted that the accounting tests for impairment are stringent. If the impairment does not follow IAS 36, then HMRC is likely to challenge the deduction, effectively reinstating the asset for tax purposes.

Is this silver lining tarnished?

At first, this accelerated deduction may seem like a fillip of good news to the unfortunate business having to impair their properties. One would typically be sure that jam today trumps jam tomorrow. However, when considering the net present value of the tax deduction, it is important to remember the rising tax rate.

An upfront deduction of 19% of an impairment might be worth less to a business than 25% of right of use depreciation further down the line, depending upon their cost of capital. Similarly, a company that is making losses – not unlikely where they are impairing assets – might create tax losses that will be subject to the loss restriction rules.

Is there a sting in the tail?

Another thing to consider is that whilst the right of use asset is reduced by the impairment, the lease liability remains. Typically, this would be extinguished by the payment of cash, from balance sheet to balance sheet.

However, in light of the poor performance of this asset, it is not unlikely that a business might seek to terminate the lease early. That lease liability will then go to the income statement as profit, reduced by any exit premium paid. The profit from the reversal of the lease liability element is taxable, but any exit premium is not deductible. This is because case law has found an exit premium to be capital in nature (see Mallett v Staveley Coal & Iron Co Ltd (1928) 13 TC 772 and other cases).

Taking a step back, overall, this seems reasonable. The deduction for the impairment of the right of use asset was given on the basis of it being representative of the rental payments. If a subsequent event means the rental payments no longer have to be made, then it cannot be unexpected that the deduction given is, in effect, clawed back. The accounting does this without a tax adjustment being required. That lease exit premiums are not deductible is something all businesses have had time to come to terms with!

Again, a reasonably likely downside particular to the timing of events might mean that a business receives a significant tax deduction on an impairment whilst the tax rate is at 19%, only to have a taxable profit arise on surrender at 25%.

Difference to IAS 17: Is this anything new?

Under IAS 17 (and FRS 102), many of the leases described above would be treated as operating leases. There would be no right of use asset, nor would there be a lease liability. However, under IAS 37 a company would be required to consider whether there was an onerous contract.

Where that provision is made in line with GAAP, it is tax deductible, as demonstrated by Herbert Smith v Honour [1999] STC 173. Similarly, where an onerous provision is reversed, the result is taxable, so the ‘sting in the tail’ point remains.

There is therefore no difference in the tax treatment of an impairment of a right of use asset or providing for an onerous lease. But do the accounting tests differ? For a provision to be made, IAS 37 defines an onerous contract as ‘a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it’.

In effect, this is a similar test to the impairment test for an IFRS 16 right of use asset. However, there are a few differences:

- Under IFRS 16, a lease might form part of a cost generating unit (CGU), along with other assets, or perhaps will be separately allocated across several CGUs. This might prevent an impairment where an onerous contract might exist; or may create impairment where no onerous contract exists.
- Under IAS 17, the IAS 37 definition tended to focus on a lease contract-by-contract basis. There is an argument that trading losses might arise not just from that lease contract, but also from other costs such as labour or goods. This could be the cause of the perception that onerous contracts on leases can only arise where a property is made vacant. This may mean that an onerous contract provision is less likely than an impairment.
- Regardless of the rules, most tax professionals considering accounts prepared under IFRS are likely to be reliant on the financial statements they receive and the accountants that prepare them. It is therefore useful to remember that most accountants will look at what is in front of them (i.e. their balance sheet assets), rather than what is not, which is a potentially onerous lease. This means it is possible for an impairment under IFRS 16 to be more likely than a provision under IAS 17.

Conclusion

The impairment of a right of use asset, as long as it is in line with GAAP, is deductible. This can accelerate tax deductions, but perhaps that’s not quite always as good as it sounds!